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## THE SUPREME COURT ON FEDERAL TAXATION, 1939-40\*

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THERE is some analogy between the Supreme Court and a law school. Each offers annual courses in the more important fields of law. In each case, the curriculum remains measurably constant, but successive instructors teach their courses differently. It is even possible that what was good law in the taxation course in 1935 is no longer good law in the taxation course in 1940. But there are important differences between the Court, the law school, and their respective students. Whereas the student who takes the 1940 taxation course is examined only on the 1940 course, the lawyer must be able to pass an examination on the 1935 and the 1920 and even the 1894 courses as well. Moreover, the Court, unlike the law school, does not give complete courses in any subject in any one year. The lawyer must somehow fill in the blanks in the 1940 course with excerpts from all the prior courses. Worse yet, he must make the attempt to determine how the present Court would modify its pronouncements of prior years, should it ever decide to discuss the subject again. None of this makes for certainty in the law, but it does stimulate intellectual agility on the part of lawyers, particularly tax lawyers, whose subject happens to be by all odds the chief matter of concern of the Court at the present time. And as lawyers we are entitled to review the work of the highest court of review; to consider whether the recent contributions of the Court to our subject have advanced the science, and made it more intelligible, or have led us into blind alleys from which Congress or the Court must some day extricate us.

The purpose of this paper is only to discuss the two dozen cases on fed-

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eral taxation which the Supreme Court decided during the October 1939 term. Such unity and coherence as it possesses comes only from the fact that all these decisions proceeded from a single tribunal; the subject-matter is very diverse, and inadequate to the formulation of a complete philosophy on any of the topics considered. Moreover, the discussion, because of time and space limitations, can be only a prelude to later more exhaustive analyses of the problems considered in the decisions. A long paper on corporate reorganizations can be written around the case of *LeTulle v. Scofield*;<sup>1</sup> on gift taxation around the decision in *Estate of Sanford v. Com'r*;<sup>2</sup> and on estate and gift taxation around *Helvering v. Hallock*.<sup>3</sup> For convenience I am limiting discussion to three main categories: the income tax, the estate tax, and the gift tax. In number, most of the tax cases during the October 1939 term involved the income tax; yet equally significant contributions were made in respect to the gift tax and the estate tax.

## I. THE INCOME TAX

### A. ALIMONY AND SHORT TERM TRUSTS

In the trusts field, Congress and the Court have long been confronted with three underlying propositions. (1) By the use of trusts, a man of property can divide income otherwise taxable to him at progressive rates among beneficiaries who may be members of his immediate family, and whom he would normally provide with similar amounts for living expenses. (2) Thus the rigors of the tax can largely be abated by some wealthier taxpayers, with resultant unequal application of the tax to similar situations, as well as loss of revenue. (3) The Congress has covered some but not all of the possible situations with explicit statutory provisions. Neither alimony trusts nor short term trusts are specifically provided for, though the Treasury seven years ago asked for a statutory amendment as to the latter.<sup>4</sup> In situations not explicitly covered, is the income of the particular trust taxable under the general rule to the beneficiary who receives it; or should the Court attempt to do in some cases what Congress failed to do—seek to obviate avoidance by holding the income taxable to the settlor by a judicially enacted exception to the general rule?

<sup>1</sup> 308 U.S. 415 (1940), noted in 53 Harv. L. Rev. 683 (1940); Continuity of Interest in Reorganization under the Federal Income Tax, 49 Yale L.J. 1079 (1940).

<sup>2</sup> 308 U.S. 39 (1939), noted in 38 Mich. L. Rev. 566 (1940). See Magill, The Federal Gift Tax, 40 Col. L. Rev. 773 (1940).

<sup>3</sup> 309 U.S. 106 (1940), noted in 53 Harv. L. Rev. 884 (1940); Inter Vivos Transfers and the Federal Estate Tax, 49 Yale L.J. 1118 (1940).

<sup>4</sup> Statement of the Acting Secretary of the Treasury, p. 18, par. (6) (1933).

In the early days of the income tax, the Court in *Gould v. Gould*<sup>5</sup> held that alimony paid by a husband to his wife was not taxable income to her; and by way of dictum, that the husband's taxable income was not decreased by the payment. Generally income is taxable to the recipient; exceptions are cases in which one's obligations are being discharged by the payment to another, or cases in which one retains control over the earning of the income and its payment to another.<sup>6</sup> If the alimony has the sanction of a judicial decree, there is an obligation resting on the husband to pay it; and in any case, the husband may be under a duty to support. On this basis, the court decided not so long ago in *Douglas v. Willcuts*<sup>7</sup> that the income of a trust set up by the husband for the benefit of a wife about to be divorced, and sanctioned by the divorce decree, was taxable to the husband. If, however, the creation of the trust is in complete satisfaction of the husband's obligation to support, and cannot thereafter be modified, the case is not dissimilar to the settlement of any contract claim by a single payment.<sup>8</sup> The original obligation has been extinguished; and when subsequent payments of income are made, they are not in discharge of any existing duty of support owed by the husband.

On this analysis, the Court held in *Helvering v. Fuller*<sup>9</sup> that the former husband was not taxable on the income of a trust to pay alimony, since the Nevada court retained no power to modify the decree, nor did the settlor underwrite the principal or income from the trust. In *Helvering v. Leonard*<sup>10</sup> and *Helvering v. Fitch*<sup>11</sup> the husband-settlor was held taxable on the income, on the ground that it had not been conclusively shown that, under the applicable state law, the state court had no remaining power to modify the alimony decree. Thus the husband's duty of support had not been completely discharged. Mr. Chief Justice Hughes, Mr. Justice McReynolds and Mr. Justice Roberts dissented without opinion in the *Leonard* case; and Mr. Justice McReynolds in the *Fitch* case. Mr. Justice Reed dissented with an opinion in the *Fuller* case; and concurred specially in the *Leonard* and *Fitch* cases. His premise is that "the basis for that decision [*Douglas v. Willcuts*] was the prior appropriation by the creation of the trust, of future income to meet an obligation of the tax-payer." If the local law created a duty to support, Mr. Justice Reed thinks the trust

<sup>5</sup> 245 U.S. 151 (1917).

<sup>6</sup> See Magill, Taxable Income 398-99 (1936).

<sup>7</sup> 296 U.S. 1 (1935); Magill, Taxable Income 242 (1936).

<sup>8</sup> See Paul, Five Years with *Douglas v. Willcuts*, 53 Harv. L. Rev. 1 (1939).

<sup>9</sup> 310 U.S. 69 (1940). See Ray, The Income Tax on Short Term and Revocable Trusts, 53 Harv. L. Rev. 1322 (1940).

<sup>10</sup> 310 U.S. 80 (1940).

<sup>11</sup> 309 U.S. 149 (1940).

income should be taxable to the husband, whether or not under the local law, the state court has the power to modify its decree.

Since the majority decisions thus turn on questions of the local law of divorce, a considerable diversity of decisions may be anticipated. Moreover, the chosen line of demarcation—the power of the particular state court to modify its decree—will not be particularly easy to draw.<sup>12</sup> One is led, like Mr. Justice Reed, to question the premises for the decisions; but one may well go back of his starting point, *Douglas v. Willcuts*,<sup>13</sup> in seeking a more promising *ratio decidendi*.

The basic reason why payments of income in discharge of the taxpayer's obligations should be taxable to him is the benefit which he may thus derive.<sup>14</sup> The benefit is obvious enough if the recipient of the income of a trust set up by a husband is his creditor, his wife or his minor child to whom or on whose behalf he would otherwise make similar payments. In the latter cases, the decisions have reached a result<sup>15</sup> similar to that reached in Great Britain by statute<sup>16</sup>—the family may fairly be taxed as a unit. If, however, the unity of the family is being broken by a divorce, as one result of which the former wife is to receive income from a trust, the obligation of the husband to support his wife does not seem a very satisfactory reason for taxing to him rather than to the ex-wife this income which he does not and cannot receive. Certainly the arrangement is not designed, as a family settlement unconnected with divorce or separation often is, to reduce the income taxes otherwise payable by the group. Moreover, it is hard to see any real benefit to the ex-husband, year after year, which can properly be said to constitute income to him. There is no such increase in economic worth as would arise from payments to an ordinary creditor. Rather it would seem more equitable that alimony payments should be taxable to the recipient, not the payor; and the income from alimony trusts to the recipient, not the settlor. On this basis, *Gould v. Gould* was a chivalrous, but unfair decision; *Douglas v. Willcuts*, a misapplication of the discharge-of-obligation analysis; and the three recent cases, a logical but undesirable refinement of the *Douglas* case theorem. The Supreme Court brushed aside landmarks in other fields; it might very properly have developed a new analysis here.

<sup>12</sup> See on this point Mr. Justice Reed's dissent in *Helvering v. Fuller*, 310 U.S. 69, 76 (1940).

<sup>13</sup> 296 U.S. 1 (1935).

<sup>14</sup> See *Magill*, *Taxable Income* 240-41 (1936).

<sup>15</sup> See *Helvering v. Schweitzer*, 296 U.S. 551 (1935); *Helvering v. Stokes*, 296 U.S. 551 (1935); *Magill*, *Taxable Income* 242 et seq. (1936).

<sup>16</sup> See *Income Tax Act 1918*, 8 & 9 Geo. V, c. 40, § 8; *Gen. Rules 16, 17*; *Finance Act 1927*, 17 & 18 Geo. V, c. 10, § 42(9).

*Helvering v. Clifford*,<sup>17</sup> in which the Court held that the income of a short term trust is taxable to the husband-settlor, is also an extension of the income tax statute by the Court, but a desirable one. On the basis of statutory history and the usual rules of statutory construction, a contrary result could more easily have been reached, as Mr. Justice Roberts showed in a dissent. The more difficult problem, however, is the scope of the holding—a matter that will now have to be pieced out through many lower court and then a few Supreme Court decisions.

In the *Clifford* case the husband declared himself trustee of certain securities for the benefit of his wife for a term of five years, subject to prior termination at the death of either spouse. During the term of the trust, the husband was to pay the wife such portions of the income as he might determine; at its termination, she was to receive any accrued income, but he was to have back the corpus. He retained extensive powers of management. The husband paid a gift tax at the time the trust was created. The Supreme Court held that the income was all taxable to the husband under Section 22(a) of the Internal Revenue Code, defining gross income in broad terms; in the companion case of *Helvering v. Wood*<sup>18</sup> it held that Section 166, dealing with revocable trusts, was not broad enough to accomplish that result. In both cases, it was brought out that the Treasury had recommended in 1934 that Section 166 be extended to the income of short term trusts, but Congress did not act. Hence, the petitioners argued in each of the two cases that this statutory history showed that the law in terms does not provide for taxing to the husband this income received by his wife. Mr. Justice Roberts adopted this point of view, concurred in by Mr. Justice McReynolds.

The Treasury was shrewd in bringing the *Clifford* case to the Court as its first essay in the short term trust field, for all its factual aspects are as favorable as possible to the contention that the income should be taxable to the husband. The result reached is a fair one, though the purist would certainly prefer to see it reached by statute rather than by decision. But what is to happen when the facts are changed? What is a short term trust? Certainly one of five years or three years;<sup>19</sup> probably not one of ten years. Suppose the trustee is a trust company, the beneficiary not a relative.

<sup>17</sup> 309 U.S. 331 (1940), noted in 53 Harv. L. Rev. 1050 (1940). Cf. *Helvering v. Wood*, 309 U.S. 344 (1940), holding that § 166 of the 1934 Act does not make the income of a short term trust taxable to the settlor. See Rudick, The Problem of Personal Income Tax Avoidance, 7 Law & Contemp. Prob. 243, 258 (1940); Irrevocable Trusts and the Federal Income Tax, 49 Yale L.J. 1305 (1940).

<sup>18</sup> 309 U.S. 344 (1940).

<sup>19</sup> The lengths of the two trusts involved in the *Clifford* and *Wood* cases.

What is there in the particular taxable year which can be regarded as income to the settlor? His control over the income in that year may be nil, although he has not relinquished his complete ownership for very long. He benefits only by the intangible satisfaction of seeing the income paid as he directed; but this satisfaction may not be at all equivalent to the discharge of a "pressing social duty," found by the court in *Burnet v. Wells*.<sup>20</sup> It seems the income should then be taxed to the recipient, not the settlor. Mr. Justice Douglas may have epitomized the basis of the *Clifford* decision in the sentence: "Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position."<sup>21</sup> Thus it is benefit to, plus control by, the settlor which makes the income taxable to the settlor. In the supposed case, neither of these reasons would apply with like force. Again, we have believed hitherto that trust income was not necessarily taxable to a settlor, merely because he made himself trustee.<sup>22</sup> There is, however, much in the *Clifford* decision regarding control: "The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the 'victim of despotic power when for the purpose of taxation he is treated as owner altogether.'"<sup>23</sup> To summarize, the basic factors causing the income to be taxed to the settlor seem to be: (1) the short term of the trust; (2) the settlor's high degree of control; and (3) the fact that the income stayed in the family. Certainly one cannot be sure that the elimination of any one of these would change the result, but it would surely reduce the likelihood of a similar decision. The elimination of two would probably swing the balance in the opposite direction. Thus, the income of a four-year trust created with a trust company to send a young friend of the settlor's through college should not, it seems to me, be taxable to the settlor; but if the beneficiary is the settlor's son, it probably would be, even though he had reached his majority.

#### B. GAIN FROM THE FORFEITURE OF A LEASE

The Treasury and the courts have had much difficulty with the problem of whether and when a lessor is taxable upon some portion of the value of a building erected by the lessee on the leased property. In 1938, the Supreme Court in *M. E. Blatt Co. v. United States*<sup>24</sup> in substance over-

<sup>20</sup> 289 U.S. 670 (1933).

<sup>21</sup> 309 U.S. 331, 335-36 (1940).

<sup>22</sup> Cf. *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929), as to the estate tax; *Canfield v. Com'r*, 31 B.T.A. 724 (1934), as to the income tax.

<sup>23</sup> 309 U.S. 331, 337 (1940).

<sup>24</sup> 305 U.S. 267 (1938); see 37 Mich. L. Rev. 1111 (1939).

ruled the Treasury's regulations in so far as they provided that the lessor realized income in each year of the term in an amount equal to the depreciated value of the building at the end of the term, divided by the number of years of the lease. The Circuit Court of Appeals for the Second Circuit in *Hewitt Realty Co. v. Com'r*<sup>25</sup> came to a similar conclusion, largely on the ground that the building was not separately disposable from the land, but was merged in it. In *Helvering v. Bruun*<sup>26</sup> the lease had been cancelled on default in 1933 and the lessor had thereby obtained back the leased land, with a building on it stipulated to be worth net \$51,434.25. The commissioner taxed the lessor on this amount in 1933, and the Supreme Court upheld him. Mr. Justice Roberts noted that there was nothing to show that the building was not removable; but that in any event, "it is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital."<sup>27</sup> The result is quite consonant with the Court's past decisions, recognizing gain on exchanges of property, even of similar nature.<sup>28</sup> In the *Bruun* case the taxpayer has received back something different in kind from what he had before, and something greater in extent.<sup>29</sup> The Court has not required that an item be separately disposable in order to be income. The stipulated value of the building reduced to the possession of the lessor in the taxable year falls well within those economists' definitions<sup>30</sup> which recognize income in a mere increase in value of the property itself within the taxable year.

#### C. REORGANIZATION

In the *Clifford* decision the Court expanded the general provisions of the income tax statute to cover a case that the Treasury had asked to have covered by statute, but without success. In contrast with this approach, the Court in *LeTulle v. Scofield*<sup>31</sup> and *Higgins v. Smith*<sup>32</sup> interpreted an earlier form of the income tax statute to have the same effect as a later amendment. The *LeTulle* case is the latest development in the judicial doctrine of continuity of interest, which finds its roots in *Pinellas Ice &*

<sup>25</sup> 76 F. (2d) 880 (C.C.A. 2d 1935), noted in 35 Col. L. Rev. 1320 (1935) and 30 Ill. L. Rev. 392 (1935); see 51 Harv. L. Rev. 1114 (1938).

<sup>26</sup> 309 U.S. 461 (1940), noted in 53 Harv. L. Rev. 1206 (1940).

<sup>27</sup> 309 U.S. 461, 469 (1940). <sup>28</sup> See Magill, Taxable Income 105 et seq. (1936).

<sup>29</sup> Cf. the discussion of the realization of income from exchanges of securities, Hall, Note, 20 Ill. L. Rev. 601 (1926).

<sup>30</sup> E.g., Haig, The Concept of Income—Economic and Legal Aspects, in Haig, The Federal Income Tax 27 (1921): "Income is the money value of the net accretion to economic power between two points of time."

<sup>31</sup> 308 U.S. 415 (1940). <sup>32</sup> 308 U.S. 473 (1940); Rudick, op. cit. supra note 17, at 257.

*Cold Storage Co. v. Com'r.*<sup>33</sup> The former definition of reorganization<sup>34</sup> included the acquisition by one corporation of substantially all the properties of another, without specifying what kind of consideration the acquiring corporation must give. After concluding in the *Pinellas* case that if the consideration was cash and short term notes, no reorganization took place, the Court decided that common stock<sup>35</sup> or non-voting preferred,<sup>36</sup> even accompanied by a substantial amount of cash, or stock and bonds<sup>37</sup> gave the transferor a sufficient stake in the continuing enterprise. In the *LeTulle* case, the consideration for a transfer to A Corporation of all of B's property was \$50,000 in cash and \$750,000 in A's bonds maturing serially over a ten-year period beginning a year after the transaction. The Court held that no reorganization took place, since the transferor retained no proprietary interest in the enterprise. This result would certainly obtain under the present reorganization definition,<sup>38</sup> for the consideration must be voting stock of the acquiring corporation. It was not required by the former definition; and the *LeTulle* decision is not easily reconciled with the decision in *John A. Nelson Co. v. Helvering*,<sup>39</sup> in which although non-voting preferred and cash were received by the transferor, a reorganization was held to have occurred. The result the Court reaches in the *LeTulle* case is nevertheless desirable. Since the transferor retains no continuing proprietary interest in the enterprise, it is well to compute at once the gain or loss realized on the disposition of the property to a new owner and to collect a tax then and there. It is the type of question, however—the details of a complicated definition—which can better be worked out by Congress with the aid of the Treasury, after a thorough consideration of the numerous common cases, than by the Court, in the course of decision of only one.

<sup>33</sup> 287 U.S. 462 (1933).

<sup>34</sup> In the *LeTulle* case the 1928 law was involved; the pertinent part of the definition of reorganization read: "The term 're-organization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation) . . ." § 112(i).

<sup>35</sup> *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935).

<sup>36</sup> *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Corporate Reorganization To Avoid Payment of Income Tax*, 45 Yale L.J. 134 (1935).

<sup>37</sup> See *Helvering v. Watts*, 296 U.S. 387 (1935).

<sup>38</sup> "The term 'reorganization' means . . . (c) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation . . ." § 112(g).

<sup>39</sup> 296 U.S. 374 (1935).



## D. DEDUCTIONS

*Business expenses, interest and losses.*—Of the decisions in this section, one involved a claimed deduction for business expenses or interest, and one, a deduction for a loss, both of which were disallowed; two decisions involved deductions for depreciation, in one of which the taxpayer succeeded. In *Deputy v. duPont*<sup>40</sup> the taxpayer, the beneficial owner of a sixteen per cent interest in the duPont Company, through trusts and a holding company, had borrowed 9,000 shares of duPont stock first from one and then from another company, for the benefit of the duPont Company, which in turn wished to and did sell it to young executives. In each case the taxpayer agreed to return the stock within ten years, and meanwhile to pay the lender an amount equivalent to all dividends declared on the stock. The taxpayer used the money received by him for the shares from the duPont Company in profitable transactions in General Motors stock; and duly paid large amounts annually to the lending companies equal to the dividends declared, in lieu of purchasing and returning the duPont stock. He sought a deduction for the amount paid in 1931, either as a business expense or as interest. The majority of the Court (Roberts, J., and McReynolds, J., dissenting; Frankfurter, J., and Reed, J., concurring specially) denied the deduction on the grounds that (1) even if the taxpayer were engaged in the business of conserving and enhancing his estate, these expenses were not "ordinary"; (2) the expenses were not interest on an indebtedness, although the taxpayer owed an obligation.

Granted that deduction provisions are to be strictly construed, this interpretation is surely quite as narrow as interpretations of the taxing provisions previously discussed were broad. Presumably Mr. duPont continued to keep the loan of stock open at the expense of these payments, because he wanted to use the capital sum in his trading or investment activities. It does not require more extended analysis to see that the amounts paid to the two lending companies were paid for the use of money, and thus could properly be regarded as interest on indebtedness. It would be more of a stretch to hold that the payments constituted an ordinary and necessary business expense; but here the Court could have rested on the finding of fact of the district court that the taxpayer was engaged in business. The decision throws doubt also upon the deductibility by an investor of the rent of a safety box, fees of investment counsel, or salaries of secretaries. All of these are mentioned in the majority opinion, apparently

<sup>40</sup> 308 U.S. 488 (1940).

as deductible by an investor; but Mr. Justice Frankfurter and Mr. Justice Reed specifically disapprove.<sup>42</sup>

The best solution is a statutory amendment, making it clear that expenses fairly attributable to the collection, earning or conservation of income which is taxed shall be deductible, whether or not connected with a trade or business.

The point decided in *Higgins v. Smith*<sup>42</sup>—that a sole stockholder does not realize a deductible loss on a sale of securities to his corporation—is now covered specifically by Section 24(b) of the Internal Revenue Code,<sup>43</sup> along with other cases in which the vendor and vendee can be regarded as joining to create a tax deduction, not as dealing at arm's length. The question in the *Smith* case was whether a similar rule applied in the absence of the statutory provision enacted two years later. Both the Treasury<sup>44</sup> and the courts<sup>45</sup> had previously treated such a loss as deductible, in the absence of secret agreements to hold and transfer back, or the like. That the wholly owned corporation is a separate taxable entity from its sole stockholder is still recognized for many purposes; and it is certainly arguable that the same proposition applies to the deduction of losses on sales between the two, until a statute denies them.<sup>46</sup> That the result of the *Smith* case should be the rule, nearly all would agree; but the usually accepted division of labor between a legislature and a court would suggest that it should have been reached, as it later was, by statute rather than by decision. To change a generally accepted rule by decision in a single case, rather than by statute applicable to all future cases, leads, as it did here, to unequal treatment of similarly situated taxpayers, as well as to considerable confusion in the administration of the statute. The Court ought not to feel that it has the burden of supplying statutory omissions in the few individual cases which come before it eight or ten years after the event.

*Depreciation.*—In *Helvering v. The F. & R. Lazarus & Company*<sup>47</sup> the Court held that a lessee was entitled to depreciation on department store buildings in a case in which the property had been conveyed to a bank as

<sup>42</sup> "Expenses for transactions not connected with trade or business, such as an expense for handling personal investments, are not deductible." 308 U.S. 488, 499 (1940).

<sup>43</sup> 308 U.S. 473 (1940); Rudick, op. cit. supra note 17, at 257.

<sup>44</sup> "In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly . . . (B) . . . between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual. . . ."

<sup>45</sup> See the dissent of Roberts, J., 308 U.S. 473, 484 (1940).

<sup>46</sup> Ibid., at 484-85.

<sup>47</sup> This point is well brought out in the dissent of Mr. Justice Roberts.

<sup>48</sup> 308 U.S. 252 (1939).

security, with a lease back to the original owner. The decision is clearly correct, since the so-called lessee had a depreciable capital investment, unlike the lessee in *Weiss v. Wiener*.<sup>48</sup>

In *The Real Estate-Land Title and Trust Co. v. United States*<sup>49</sup> the Court held that the term "obsolescence" used in the statute refers to "functional depreciation"; "that the operative causes of the present or growing uselessness arise from external forces which make it desirable or imperative that the property be replaced";<sup>50</sup> and that "the desire of a management to eliminate one plant which was a needless duplication of another, but which functionally was adequate,"<sup>51</sup> is not a sufficient basis for the deduction. This interpretation appears to accord with Treasury, accounting and engineering authority. The Court left open the question whether the taxpayer might be entitled to a deduction for a loss sustained.

#### E. ADMINISTRATION-ACCOUNTING

The fragility as a weapon in a close case of the so-called canons of statutory construction is well illustrated in *Helvering v. Wilshire Oil Co.*<sup>52</sup> In this case, the canon invoked was the proposition that administrative construction receives legislative approval by reenactment of a statutory provision without material change. The Court had little difficulty in concluding that a regulation interpreting a provision of one act is not frozen into another act merely by re-enactment of the former provision, since a contrary holding would paralyze the efforts of administrative bodies to keep abreast of changes in business practice and new conditions. Mr. Justice Douglas made a mild attempt to distinguish some situations where the canon might apply,<sup>53</sup> but clearly his heart was not in his work. What he strongly felt was that the general application of the canon would cause more difficulty than any possible good.

The income tax regulations alone run to 690 pages, plus a total of perhaps a like amount of administrative learning devoted to the other federal taxes contained in current revenue acts. The fact is, then, to paraphrase the late Judge Hough,<sup>54</sup> that a knowledge of Treasury regulations is

<sup>48</sup> 279 U.S. 333 (1929).

<sup>50</sup> *Ibid.*, at 17.

<sup>49</sup> 309 U.S. 13 (1940).

<sup>51</sup> *Ibid.*

<sup>52</sup> 308 U.S. 90 (1939), noted in 53 Harv. L. Rev. 323 (1939); Alvord, Treasury Regulations and the Wilshire Oil Case, 40 Col. L. Rev. 252 (1940); Surrey, The Scope and Effect of Treasury Regulations, 88 U. of Pa. L. Rev. 556 (1940); Paul, Use and Abuse of Tax Regulations in Statutory Construction, 49 Yale L.J. 660 (1940).

<sup>53</sup> 308 U.S. 90, 100 (1939).

<sup>54</sup> "Algebraic formulae are not lightly to be imputed to legislators." *Edwards v. Slocum*, 287 Fed. 651, 654 (C.C.A. 2d 1923).

not lightly to be imputed to legislators. Indeed, how many of us have read the regulations in their entirety? How many of us would be capable of testifying what regulations now have the force of law and what have not? The fact is that the administrative and the legislative processes in taxation, while parts of one great governmental machine, operate largely independently; the cogs intermesh at comparatively few points. There was certainly some hardship to the taxpayer in the *Wilshire Oil* case to have made an election in possible reliance upon one interpretation of the law, only to find a few years later that a different and less favorable interpretation was to be imposed on it. Nevertheless, Mr. Justice Douglas, possibly moved in part by his own previous experience as an administrator, is a realist and a sound tax philosopher in concluding that the re-enactment of a statute should not be treated as a conscious and binding adoption of existing regulations, and that the Treasury is therefore free to change its rulings if it sees fit. The corollary is, of course, that the Court is equally free to strike down the interpretation, if it finds the regulation undesirable or unsound. Certainly the Court at the October 1939 term was little constricted by administrative rulings of which it disapproved.<sup>55</sup> In this country we probably have too much of an administrative tendency to publish interpretations after insufficient consideration, then to reverse the precedent after a few years, and to upset closed cases, because years later a different rule seems sounder. Most of the evil comes from a retrospective or retroactive application of the new rule. Granted, however, that formal regulations should be thoughtfully prepared, and changed only for good cause shown, the Treasury should have the power to make the change with prospective effect when later decisions, new conditions, or greater administrative experience makes it imperative, even though a statutory reenactment has intervened.

Two of the three other decisions in the income tax field follow older precedents. The Board of Tax Appeals having upheld the commissioner's finding of fraud, a circuit court of appeals may not substitute its judgment of the facts, if there were substantial evidence to support the board's conclusions.<sup>56</sup> A taxpayer on a cash, as distinct from an accrual, basis, giving a note for his liability as a guarantor, may not deduct his loss until he actually pays the note.<sup>57</sup> A fiduciary return filed in good faith on behalf of an investment trust fund, accurate in stating income, deductions and beneficiaries, is a sufficient return to start the running of the statute of limita-

<sup>55</sup> See the discussion by Stone, J., in *Estate of Sanford v. Com'r*, 308 U.S. 39, 48 (1939).

<sup>56</sup> *Helvering v. Kehoe*, 309 U.S. 277 (1940), citing a number of prior decisions.

<sup>57</sup> *Helvering v. Price*, 309 U.S. 409 (1940), following *Eckert v. Burnet*, 283 U.S. 140 (1931).

tions, even though the bureau determines three years later that the fund should be taxed as a corporation, and that therefore a corporation return should have been filed.<sup>58</sup> This seems to be the kind of case that the bureau should never have litigated at all, much less taken to the Supreme Court.

There were two other decisions as to income during the October 1939 term. *Griffiths v. Com'r*<sup>59</sup> traverses old ground in holding that "a technically elegant arrangement whereby an intricate outward appearance was given" to the settlement of a fraud claim should be taxed for what it was. As a matter of fact, it is a mild slander on the legal profession to call the arrangement either technical or elegant. *Anderson v. Helvering*<sup>60</sup> holds that the petitioners are taxable on the gross proceeds from the oil production on lands conveyed to them under their agreement to pay \$50,000 in cash and \$110,000 from one-half of the proceeds of sale of oil or gas or from the sale of the fee. The Court regarded the deferred payments as payments on a sale. The decision turned largely upon the reservation of an interest in the fee, in addition to the interest in the oil production.

## II. THE ESTATE TAX

The Supreme Court had occasion to deal with the estate tax in only two decisions, but one of these, *Helvering v. Hallock*,<sup>61</sup> was a consolidation of five different cases,<sup>62</sup> and has, moreover, far-reaching consequences in the gift tax as well as the estate tax field. It was reached by a divided court,<sup>63</sup> the majority finding it necessary to overrule two of its own decisions of only five years standing.<sup>64</sup> The material facts in the five cases differed slightly. The three Hallock trusts, part of a separation agreement, provided for income for life to the settlor's wife; upon her death the corpus was to go to the settlor if living, otherwise to the settlor's son and daughter. Under the Cassell trust, part of an antenuptial agreement, the income

<sup>58</sup> *Germantown Trust Co. v. Com'r*, 309 U.S. 304 (1940).

<sup>59</sup> 308 U.S. 355 (1939); Rudick, op. cit. supra note 17, at 256.

<sup>60</sup> 310 U.S. 404 (1940).

<sup>61</sup> 309 U.S. 106 (1940), noted in 53 Harv. L. Rev. 884 (1940); *Inter Vivos Transfers and the Federal Estate Tax*, 49 Yale L.J. 1118 (1940); Lowndes, *Tax Avoidance and the Federal Estate Tax*, 7 Law & Contemp. Prob. 309, 313, 316 (1940).

<sup>62</sup> *Helvering v. Hallock* (two cases); *Helvering v. Squire*; *Rothensies v. Huston*; *Bryant v. Helvering*.

<sup>63</sup> Frankfurter, J., delivered the majority opinion; Hughes, C. J., concurred on the ground that each of the cases was controlled by *Klein v. United States*, 283 U.S. 231 (1931); Roberts, J., and McReynolds, J., dissented in an opinion by the former.

<sup>64</sup> *Helvering v. St. Louis Union Trust Co.*, 296 U.S. 39 (1935), noted in 49 Harv. L. Rev. 661 (1936); *Becker v. St. Louis Union Trust Co.*, 296 U.S. 48 (1935); *Recent Developments in Federal Estate Taxation of Inter Vivos Trusts*, 45 Yale L.J. 684, 690 (1936).

was to be paid to the prospective wife for her life; upon her death, the corpus and accumulations were to go to the settlor if living, otherwise to the wife. The Bryant trust provided for the payment of the income to the wife for life, then to the settlor if living; upon the death of the survivor, the principal was to be paid to the executors or administrators of the settlor's estate. In each case, the settlor died before his wife. The question was whether the transfers were to be included in his gross estate under Section 302(c) of the Revenue Act of 1926, as transfers to take effect at or after death. The Court, in an opinion by Mr. Justice Frankfurter, which approved and followed *Klein v. United States*,<sup>65</sup> and expressly overruled *Helvering v. St. Louis Trust Co.* and *Becker v. St. Louis Trust Co.*,<sup>66</sup> held that they should be included in the husband's gross estate. The opinion contains much criticism of the "unwitty diversities of the law of property derived from medieval concepts" and of the *St. Louis Trust* cases for following them, plus a statement of the absence of compelling reasons, in stare decisis or interests created in reliance on such precedents, for applying the prior decisions. It is less satisfactory in its citation of the positive reasons for a different rule. Moreover, unfortunately for lawyers who must live with the rule and know its scope, there is almost nothing to indicate its precise extent. The best summary of the Court's reasoning seems to be its quotation from the *Klein* decision:

It is perfectly plain that the death of the grantor was the indispensable and intended event which brought the larger estate into being for the grantee and effected its transmission from the dead to the living, thus satisfying the terms of the taxing act and justifying the tax imposed.<sup>67</sup>

Although the cases have been sometimes spoken of as involving possibilities of reverter to the settlor, his interest in each case was more substantial. He was to take principal or income, if he survived the life beneficiary, and the passage of principal to others, as in the *Klein* case, depended upon the settlor's prior death. His death was in this respect the generating cause of the vesting of the corpus in possession in these beneficiaries. Hence, there is much to be said for the Chief Justice's conclusion that the decision in the *Klein* case was controlling. But Mr. Justice Frankfurter's main interest was in clearing away what he regarded as the debris of the two *St. Louis Trust* cases. In any event the result reached is sound. To the extent of the remainders, the transfers do in fact take effect in possession or enjoyment at or after the settlor's death. The settlor has retained a substantial interest in himself which in the Hallock and Cassell trusts would operate, if he survived the income beneficiary, his wife, to give him

<sup>65</sup> 283 U.S. 231 (1931).

<sup>66</sup> 296 U.S. 39 and 48 (1935).

<sup>67</sup> 283 U.S. 231, 234 (1931).

unencumbered ownership of the property. An interest does, therefore, pass out of him at his death. To be sure, it is not worth as much as the fee; and so, in a sense, his estate is overvalued when the value of the whole fee is included in it. But overvaluation in this sense is not peculiar to this kind of transfer; it is rather an attribute of the estate tax as compared with the inheritance tax.

More space could be devoted to a consideration of the probable extent of application of the doctrines of the case. In general, the impatience of the majority of the Court with distinctions of the law of property leads one to the belief that the present Court will give the decision rather broad application. In particular, does it apply to cases in which the settlor has set up inter vivos trusts, providing for the payment to others both of the income and the corpus, but reserving to himself a reversionary interest only if all the designated beneficiaries predecease him? To take a strong, but likely case, suppose that the income beneficiary is the settlor's wife, the remaindermen his three young children. It is evident that, as a practical matter, the settlor's reserved interest is valueless, although of course, a calamity might occur whereby all of the remaindermen would be wiped out. Must the settlor who wishes to provide for such a contingency insert as the contingent beneficiary an exempt institution? Further, to round out the discussion, should a gift tax be applicable to the creation of such a trust? The most satisfactory integration of the two taxes would seem to result from a holding that the gift tax is applicable to the extent of the value of interests created in donee-beneficiaries, for certainly valuable irrevocable interests have been created in them. The settlor would have the burden of introducing evidence as to the value of his reserved interest,<sup>68</sup> which, as stated, is rather clearly nil. By a parity of reasoning, the estate tax should not be applied.

It is by no means clear, however, that the lower courts or the Supreme Court will actually reach these results; and hence trusts draftsmen must for a time proceed with great caution. The uncertainty extends beyond the field of trusts. The Court of Claims, after much vacillation, finally concluded that the proceeds of insurance policies taken out by the decedent on his own life, and irrevocably assigned to his wife and son, who paid the premiums after the assignment, must be included in his estate, since the policies provided that if he survived the assignees, he and his estate became the beneficiaries.<sup>69</sup> In such a case, the bureau may seek to apply

<sup>68</sup> For a more extended discussion of the whole topic, see Magill, *op. cit.* supra note 2.

<sup>69</sup> *Bailey v. United States*, 31 F. Supp. 778 (Ct. Cl. 1940), noted in 53 Harv. L. Rev. 1208 (1940); see also Magill, *op. cit.* supra note 2, at 788.

both a gift tax and an estate tax, at least pending the clarification of the scope of the *Hallock* case. Certainly the *Hallock* case is the beginning, not the end, of litigation as to the meaning, not merely of that deliberately ambiguous phrase "transfers intended to take effect in possession or enjoyment at or after death," but of the insurance provision and perhaps other provisions as well.

*Morgan v. Com'r*,<sup>70</sup> the other estate tax decision, caused no division in the Court in holding that the determination of the question whether property subject to a power of appointment is to be included in the gross estate is a matter of construction of the federal statute, and does not turn on the state's definition of the particular power as special or general. The Court, through Mr. Justice Roberts, succinctly stated the distinction thus:

State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. . . . If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.<sup>71</sup>

Presumably, the local law should, therefore, be examined "to ascertain whether a power would be construed by the state court to permit the appointment of the donee, his estate or his creditors," and on the basis of the answer to that inquiry "the federal court would determine whether the power was general within the intent of the federal act."

### III. THE GIFT TAX

It was settled seven years ago by *Burnet v. Guggenheim*<sup>72</sup> that a transfer in trust subject to a power of revocation in the settlor became a taxable gift only when the power was relinquished. Both the Treasury and taxpayers remained in doubt<sup>73</sup> regarding liability to gift taxation in the case of a transfer subject to a power to change beneficiaries, but not in favor of the settlor. On the one hand, the settlor has parted with the most substantial of his property interests. On the other, the donees are not yet ascertained, or their secondary liability fixed. The settlor might even designate a charity and defeat the tax. Most important, perhaps, is the fact that a transfer subject to such a power will be included in the settlor's estate.<sup>74</sup> Since the gift tax is supplementary to the estate tax, it may properly be held not to apply.

<sup>70</sup> 309 U.S. 78 (1940).

<sup>71</sup> *Ibid.*, at 80-81.

<sup>72</sup> 288 U.S. 280 (1933).

<sup>73</sup> See the discussion of administrative practice in *Estate of Sanford v. Com'r*, 308 U.S. 39, 48 (1939).

<sup>74</sup> *Porter v. Com'r*, 288 U.S. 436 (1933), noted in 32 Mich. L. Rev. 563 (1934) and 18 Minn. L. Rev. 235 (1934).



In *Estate of Sanford v. Com'r*<sup>75</sup> the Court held that the relinquishment of the power to alter beneficiaries but not in the settlor's favor was a taxable gift. In the companion case of *Rasquin v. Humphreys*<sup>76</sup> the Court held that there was no completed gift, so long as the settlor retained such a power. Thus, gift tax liability can be avoided at will at the time of the creation of a trust by the insertion of clauses giving the settlor the power of adding new beneficiaries, or changing old ones.<sup>77</sup>

The revenue acts have been drawn on the basis that if a particular transfer has been subjected to a gift tax, and is also included in the gross estate, a credit for the gift tax should be allowed against the estate tax.<sup>78</sup> The two taxes, therefore, are not intended to duplicate each other but to be supplementary. If the grantor has retained such powers over the ultimate disposition of the whole property that the estate tax will be applicable, it is reasonable to hold that he has not yet made a gift. The more serious question is whether the Court meant that in no case, save a gift in contemplation of death, should both taxes be applicable. Mr. Justice Stone said:

There is nothing in the language of the statute, and our attention has not been directed to anything in its legislative history to suggest that Congress had any purpose to tax gifts before the donor had fully parted with his interest in the property given, or that the test of the completeness of the taxed gift was to be any different from that to be applied in determining whether the donor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death. The gift tax was supplementary to the estate tax. The two are in *pari materia* and must be construed together.<sup>79</sup>

Suppose a husband has caused the creation of a joint tenancy or a tenancy by the entirety in himself and his wife, having supplied all the consideration himself. The husband has retained an interest in the property which will cause its inclusion at its full value in his gross estate.<sup>80</sup> Is the transfer therefore not subject to gift taxation? It is clear that the husband has completely parted with a valuable property interest. In the case of a joint tenancy his wife may be entitled, for example, to sever her interest;

<sup>75</sup> 308 U.S. 39 (1939).

<sup>76</sup> 308 U.S. 54 (1939). An earlier decision to the same effect is *Hesslein v. Hoey*, 91 F. (2d) 954 (C.C.A. 2d 1937), cert. den. 302 U.S. 756 (1937), noted in 5 Univ. Chi. L. Rev. 521 (1938) and 23 Corn. L.J. 464 (1938). See also *Wales*, "Indian" Gifts, 34 Ill. L. Rev. 119 (1939); 50 Harv. L. Rev. 995 (1937).

<sup>77</sup> The significance and scope of the decisions are more fully discussed in *Magill*, op. cit. supra note 2, at 780 et seq. Some of the discussion herein is a paraphrase of what appears there.

<sup>78</sup> See Int. Rev. Code § 813(a) (1939). The credit is not entirely adequate, however, since the credit otherwise allowable for state death taxes is decreased thereby.

<sup>79</sup> *Estate of Sanford v. Com'r*, 308 U.S. 39, 44 (1939). <sup>80</sup> Int. Rev. Code § 811(e) (1939).

in the case of a tenancy by the entirety, she may, under the local law, share in its rents, and be able to prevent its attachment for other than joint debts.<sup>81</sup> For these reasons the circuit court of appeals decisions sustain the Treasury in holding that the creation of a tenancy by the entirety by a husband through the use of his own funds is a taxable gift.<sup>82</sup> These decisions appear to be good law, notwithstanding the *Sanford* decision. The test of a taxable gift should be, it seems, whether the transferor completely relinquished, inter vivos, ownership and control of interests in the property having an ascertainable value. If he has, a gift tax should be applied, even though the estate tax may also be applicable. Thus, if the settlor has transferred property in trust but has reserved some reversionary interest, like that in *Helvering v. Hallock*,<sup>83</sup> or a less substantial interest, there should be held to be a taxable gift to the extent of the value of the interest created in donee beneficiaries. Nevertheless the result is not yet certain.<sup>84</sup>

#### IV. MISCELLANEOUS TAXES

Two decisions complete the taxation cases adjudicated by the Supreme Court during the October 1939 term. In *Haggard Co. v. Helvering*<sup>85</sup> it was held that a capital stock tax return filed pursuant to Section 215 of the National Industrial Recovery Act of 1933<sup>86</sup> may be amended within the time for filing the return, as extended by the Treasury, a result reached in 1938 by statute.<sup>87</sup> The Treasury regulations to the contrary were rejected. In *The Sunshine Anthracite Coal Co. v. Adkins*<sup>88</sup> the Bituminous Coal Act of 1937<sup>89</sup> was upheld, including provisions whereby an excise tax of one cent a ton was imposed upon sales of bituminous coal by a producer; and an additional nineteen and one-half per cent tax upon non-code members. The Court found that the tax was a sanction to enforce the regulatory provisions of the act, not intended for revenue purposes; and that "the power of taxation, granted to Congress by the Constitution, may be utilized as a

<sup>81</sup> See *Com'r v. Hart*, 106 F. (2d) 269 (C.C.A. 3d 1939).

<sup>82</sup> *Lilly v. Smith*, 96 F. (2d) 341 (C.C.A. 7th 1938), cert. den. 305 U.S. 604 (1939), noted in 17 N.C.L. Rev. 71 (1938); *Com'r v. Hart*, 106 F. (2d) 269 (C.C.A. 3d 1939); *Com'r v. Logan*, 109 F. (2d) 1014 (C.C.A. 3d 1940) (on the authority of the *Hart* case). See Federal Gift Tax on Transfers Creating Estates by Entireties, 47 Yale L.J. 1213 (1938); 37 Mich. L. Rev. 340 (1938).

<sup>83</sup> 309 U.S. 106 (1940).

<sup>84</sup> For more elaborate discussion see Magill, op. cit. supra note 2, at 787-88.

<sup>85</sup> 308 U.S. 389 (1940).

<sup>86</sup> 48 Stat. 195, 207 (1933).

<sup>87</sup> 52 Stat. 447, 565 (1938). See Int. Rev. Code § 1203 et seq. (1939).

<sup>88</sup> 310 U.S. 381 (1940).

<sup>89</sup> 50 Stat. 72 (1937), 15 U.S.C.A. § 828 (1939).

sanction for the exercise of another power which is granted it." The provisions of the act were found to be an exercise of the federal power over interstate commerce.

#### CONCLUSION

It is evident that one can hardly deduce a well-rounded philosophy of taxation from these comparatively few decisions of a single year. A few tendencies are observable, which may crystallize into an established point of view or mode of attack, or may, of course, be much modified or abandoned. The taxing provisions of the revenue laws have been broadly construed; the general definition of income,<sup>90</sup> and the scope of the estate tax<sup>91</sup> are greater than was thought. The exemption<sup>92</sup> and deduction provisions,<sup>93</sup> on the other hand, have been quite strictly construed. In these respects, accepted canons of statutory construction have been followed. On the other hand, legislative history has not been given much weight,<sup>94</sup> nor has the reenactment of a provision been treated as the adoption of Treasury regulations promulgated under the original section.<sup>95</sup> In general, it seems the Court will work out its own interpretation of the revenue laws, without too much regard for legislative, or even judicial, history or Treasury regulations; and its approach will be to give the laws a broad application. The taxpayer cannot count on a close technical interpretation; if his case is within the general spirit of the taxing sections, as the Court views it, he will be held liable, even though the Treasury can hardly point to a specific provision covering the situation. The Court may be regarded as responding thus to the great need of the national government for revenue. It is probable, however, that its response is rather the normal one of fresh minds on a new job. The new Court has upset some landmarks; it has raised many new uncertainties; lawyers must examine again their analysis of some of the old basic theses.<sup>96</sup> The most serious criticism is that some of the work should have been done, and can be better done, by Congress rather than by the Court. Nevertheless, the *results* of the year's work are almost wholly salutary, and that is the highest praise a realist could bestow.

<sup>90</sup> *Helvering v. Clifford*, 309 U.S. 331 (1940).

<sup>91</sup> *Helvering v. Hallock*, 309 U.S. 106 (1940).

<sup>92</sup> *LeTulle v. Scofield*, 308 U.S. 415 (1940); for this purpose, the reorganization definition may be classified as an exemption provision.

<sup>93</sup> *Deputy v. duPont*, 308 U.S. 488 (1940); *Higgins v. Smith*, 308 U.S. 473 (1940); *Real Estate-Land Title & Trust Co. v. United States*, 309 U.S. 13 (1940).

<sup>94</sup> See the discussion of the Clifford decision, p. 5 *supra*.

<sup>95</sup> *Helvering v. Wilshire Oil Co.*, 308 U.S. 90 (1939).

<sup>96</sup> Cf. Ballantine, *Business without Precedents*, 166 *Atlantic Monthly* 235 (1940).